First Trust

Quarterly Market Overview

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We invite you to visit Bob's Market Commentary Blog at www.ftportfolios.com for more insight.

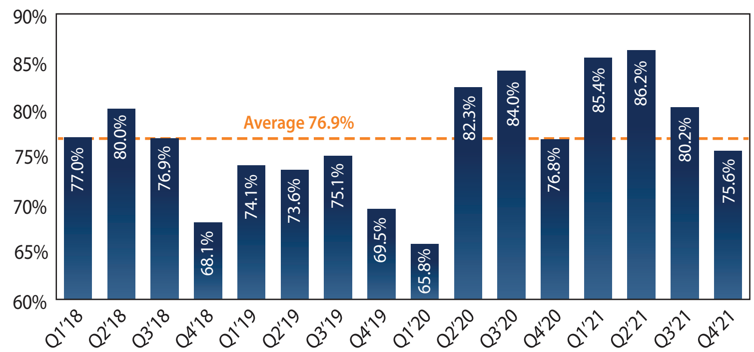
## Corporate earnings estimates remain fairly upbeat despite economic headwinds and recession fears

**S&P 500 Index & Sectors** (2022 Consensus Earnings Estimates in U.S. Dollars)

| Index | 1/22 | 2/22 | 3/22 | 4/22 | 5/22 | 6/22 |
|---|---|---|---|---|---|---|
| S&P 500 | 221.47 | 223.13 | 225.79 | 226.75 | 227.64 | 227.63 |
| Communication Services | 13.27 | 13.17 | 13.03 | 12.78 | 12.63 | 12.59 |
| Consumer Discretionary | 52.51 | 53.34 | 52.51 | 49.51 | 48.13 | 46.70 |
| Consumer Staples | 35.96 | 36.13 | 36.07 | 35.96 | 35.81 | 35.80 |
| Energy | 41.38 | 43.63 | 53.97 | 60.27 | 66.34 | 69.33 |
| Financials | 44.01 | 43.42 | 43.38 | 43.67 | 43.19 | 42.85 |
| Health Care | 96.80 | 97.17 | 96.71 | 96.11 | 95.63 | 95.57 |
| Industrials | 41.76 | 41.70 | 41.53 | 42.16 | 42.40 | 42.53 |
| Information Technology | 106.32 | 108.45 | 108.76 | 108.89 | 108.80 | 109.07 |
| Materials | 33.61 | 34.05 | 35.08 | 36.61 | 38.24 | 37.99 |
| Real Estate | 6.54 | 6.68 | 6.63 | 6.81 | 7.07 | 7.28 |
| Utilities | 17.41 | 17.46 | 17.41 | 17.45 | 17.39 | 17.46 |

*Source: Bloomberg*

**% of S&P 500 Companies That Beat Their Quarterly Earnings Estimates**




*Source: S&P Dow Jones Indices.*

As we head into the Q2'22 corporate earnings season, we thought it would be an opportune time to briefly discuss what is potentially at stake in the current climate, particularly with respect to the direction of the stock market. Since the onset of the COVID-19 pandemic in Q1'20, it seems like there has been a notable disconnect between the state of the economy ("Main Street") and the performance of the stock market ("Wall Street"). While the U.S. economy has struggled to fully recover from its partial shutdown during the first half of the pandemic, the stock market was clearly in rally mode up until the start of 2022.

Robust inflation, global supply-chain bottlenecks, the war between Russia and Ukraine, which commenced in late February of this year, and the COVID-19 shutdown in China have been huge drags on the economy and stock market so far in 2022, in our opinion. These headwinds combined with an annualized real U.S. GDP growth rate of -1.6% in Q1'22 have some pundits and the financial media saying that we could be on the cusp of a recession. The technical definition of a recession is two consecutive quarters of negative GDP growth. The next GDP release (Q2'22) is set for 7/28/22.

Obviously, opinions on this topic vary. In fact, there are pundits that believe the U.S. economy is already in recession. Brian Wesbury, Chief Economist at First Trust L.P., is not one of them. Wesbury notes that the official arbiter of recessions, the National Bureau of Economic Research, considers other factors beyond just real GDP, including the job market, which is currently healthy, manufacturing activity and real incomes. While subject to change, Wesbury does not foresee a recession arriving until late 2023 or 2024.

The trillions of dollars of monetary and fiscal stimulus pumped into the U.S. economy by the federal government to help mitigate the fallout from the pandemic has ignited inflation. The Federal Reserve's ("Fed") quantitative easing (bond buying) increased its balance sheet of assets from $5.81 trillion at the start of Q2'20 (COVID-19 onset) to $8.91 trillion at the close of Q2'22, according to Bloomberg. Actions, however, can have unintended consequences. The Fed has a plan to bring down inflation. It includes raising interest rates (underway) and a gradual paring of its balance sheet.

The U.S. stock market, as measured by the S&P 500 Index, slid into bear market territory in Q2'22. A bear market reflects a 20% or more price decline from the most recent peak of a security or index. The S&P 500 Index was down by as much as 23.55% on a price-only basis (dividends not included) from its all-time closing high posted on 1/3/22, according to Bloomberg. What managed to derail the bull market? Fed interest rate hikes and the accompanying rise in bond yields. The daily closing yield on the benchmark 10-year Treasury Note rose 151 basis points, from 1.51% on 12/31/21 to 3.02% on 6/30/22. That is a significant jump over such a short span. The federal funds target rate (upper bound) also rose 150 basis points, from 0.25% on 12/31/21 to 1.75% on 6/30/22. That is as textbook as it gets, in our opinion.

Why have rising bond yields been problematic for this bull market? The short answer is that rising Treasury yields beget higher yields on corporate bonds and that translates into an increase in the cost of capital for companies, which can cut into profits. Remember, the stock market is a forward-looking mechanism that reflects valuations based on future earnings expectations. With stock prices sitting at record levels, valuations were poised to fall. The strengthening U.S. dollar is another potential drag on profits.

Earnings estimates from Wall Street analysts are fluid. The table at the top left of this page shows how estimates for the S&P 500 Index and its sectors have fluctuated over the first six months of 2022. The chart directly above shows the percentage of S&P 500 Index companies that have beaten their estimates on a quarterly basis. Wall Street analysts remain optimistic, perhaps too upbeat, in our opinion, about earnings growth in 2022. Bloomberg's consensus year-over-year earnings growth rate estimate for the S&P 500 Index for 2022 was 10.37% as of 7/1/22. Analysts are looking for 8.49% earnings growth in 2023. The optimism in the current climate also extends to stock ratings. Data compiled by Bloomberg indicates that companies in the S&P 500 Index currently have an average consensus rating of 4, based on a scale of 1 (sell) to 5 (buy), the highest reading since 2002. Lastly, a Bloomberg survey of 23 equity strategists found that their average 2022 year-end price target for the S&P 500 Index was 4,617 as of 6/15/22, which would be a significant jump from its 3,785 level at the close on 6/30/22.



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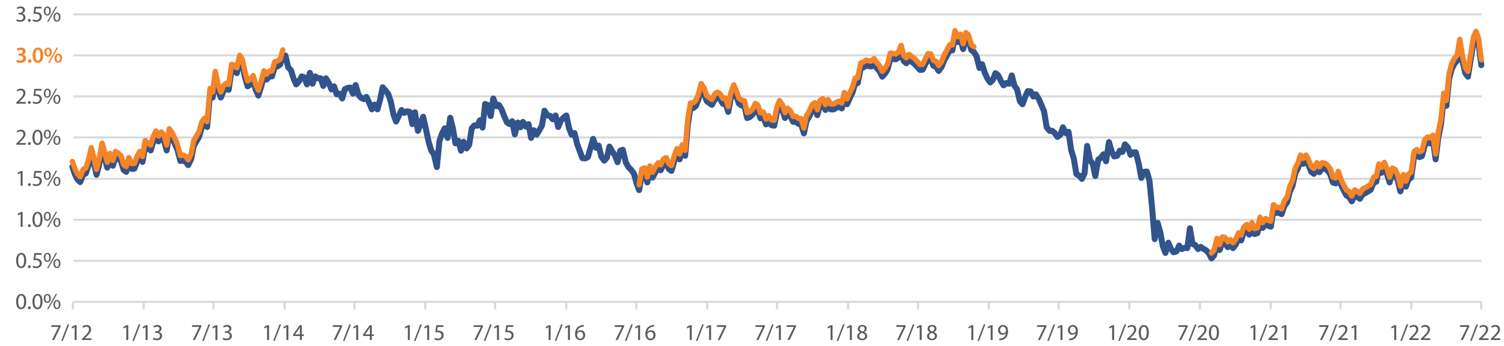
## Interest rates and bond yields attempting to normalize for the third time in a decade

**10-Year T-Note Yields**

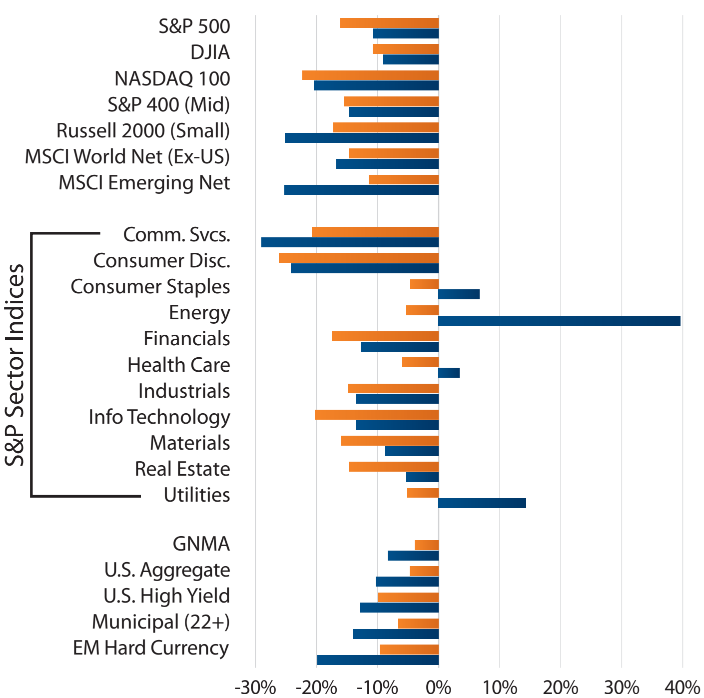



*Source: Bloomberg. Weekly data points from 6/29/12-7/1/22.*

Over the past decade or so, the ceiling for the yield on the 10-year T-note has been 3.00%. We know that all of the quantitative easing measures initiated by the Fed dating back to the 2008-2009 financial crisis to stimulate economic activity have been effective in keeping Treasury yields artifically low. The current rise in this benchmark bond yield is its third attempt at surpassing the 3.00% mark since 2011. As indicated by the orange shading in the chart above, the first two attempts did top the 3.00% mark but it was short-lived. The yield on the 10-year T-note (close of trading) peaked at 3.03% during the 2013 run up and at 3.24% during its ascension in 2018. The peak this year was 3.48% (June). What makes the current climate different from 2013 and 2018? Inflation. The Consumer Price Index (CPI) stood at a rate of 9.1% in June 2022 on a trailing 12-month basis, the highest it has been since the early 1980s. Its high points in 2013 and 2018 were 2.0% and 2.9%, respectively, according to data from the Bureau of Labor Statistics. For comparative purposes, the CPI rate has averaged 3.0% per year since the start of 1926. The yield on the 10-year T-note stood at 3.02% at the close on 6/30/22. Will it remain above 3.00% for a sustained period this time? We'll see. Here are a few a few things to monitor in the coming months:

- The Fed has announced its intention to pare down its balance sheet of assets. Over the first three months, it will reduce it by $47.5 billion per month. After that, it ramps up to $95 billion per month. The $95 billion will be split as follows: $60 billion in Treasuries and $35 billion in mortgage-backed securities. While this reduction in holdings will be a gradual process, it could impact bond yields on the margin over time.
- The yield spread between the 2- and 10-year T-note is being closely watched by those who believe it can portend a recession lurking out a year or two, providing that this part of the yield curve inverts (2-year yields more). This spread stood at a positive six basis points on 6/30/22.
- Investors seeking current income should welcome higher bond yields, especially with inflation soaring. As of 6/30/22, the real rate of return (yield minus inflation rate) on the 10-year T-note was -6.08% (3.02% minus 9.1%), which is lousy. Bond investors benefit from a positive real rate. For the 30-year period ended 6/30/22, the average real rate on the 10-year T-note was 1.55%, according to Bloomberg. Normalization of interest rates and bond yields is overdue, in our opinion.

### Total returns for Q2 and past 12 months (6/30/22)




*Sources: Bloomberg and Bloomberg Fixed Income Indices.* ***Past performance is no guarantee of future results.***

### A Look Ahead:

*A year-over-year earnings comparison in U.S. dollar terms (per share). The S&P 500 Index dollar figures reflect the 11 major sectors on a weighted-adjusted basis.*

| Index (Weighting In S&P 500) | **Q3'22E** | Q3'21A | **Q4'22E** | Q4'21A | **2022E** | 2021A |
|---|---|---|---|---|---|---|
| Communication Svcs. (8.9%) | **3.06** | 3.06 | **3.39** | 3.13 | **12.14** | 12.44 |
| Consumer Disc. (10.5%) | **13.08** | 10.18 | **12.75** | 13.37 | **42.16** | 45.29 |
| Consumer Staples (7.0%) | **9.41** | 9.31 | **9.19** | 8.90 | **35.55** | 35.12 |
| Energy (4.4%) | **19.75** | 9.50 | **17.61** | 12.52 | **71.25** | 31.08 |
| Financials (10.8%) | **10.95** | 12.48 | **11.47** | 16.06 | **43.57** | 59.26 |
| Health Care (15.1%) | **24.11** | 21.56 | **22.89** | 18.86 | **90.26** | 78.09 |
| Industrials (7.8%) | **11.95** | 8.95 | **11.75** | 8.49 | **42.57** | 31.88 |
| Information Tech. (26.8%) | **26.98** | 23.52 | **32.33** | 27.05 | **108.65** | 93.50 |
| Materials (2.6%) | **9.63** | 8.03 | **9.09** | 7.92 | **38.38** | 30.52 |
| Real Estate (2.9%) | **1.74** | 2.03 | **1.69** | 2.37 | **7.16** | 8.00 |
| Utilities (3.1%) | **5.49** | 4.76 | **3.49** | 2.75 | **17.24** | 15.27 |
| S&P 500 Index | **59.23** | 52.02 | **60.46** | 56.73 | **224.06** | 208.20 |
| S&P MidCap 400 Index | **48.68** | 38.04 | **49.51** | 45.89 | **184.17** | 153.84 |
| S&P SmallCap 600 Index | **24.14** | 17.16 | **25.66** | 25.80 | **86.80** | 74.25 |

*Source: S&P Dow Jones Indices (6/29/22). Sector weightings as of 6/30/22. There is no guarantee past trends will continue or projections will be realized.*

*All charts and tables herein are for illustrative purposes only. Indices do not charge management fees or brokerage expenses, and no such fees or expenses were deducted from the performance shown. Indices are unmanaged and an investor cannot invest directly in an index.*

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